Re-Evaluating Total Shareholder Return as an Incentive

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As executive pay design has evolved, relative total shareholder return (rTSR) has become one of the most prevalent measures in long-term incentive (LTI) plans by a wide margin. Several factors have caused the rise in popularity of rTSR, including the role of TSR as the ultimate test of performance, the influential role of proxy advisers, newly proposed U.S Security and Exchange Commission disclosure mandates and the simplicity with which a rTSR plan can be implemented.
Incentive plans are meant to achieve key business objectives and shareholder value creation is an ultimate business objective by which incentive plans can either use TSR as the measure of performance or select intermediate performance measures that clearly drive TSR over the long term.

However, recent empirical research from Pearl Meyer and the Cornell University ILR Institute for Compensation Studies (ICS) turns the conventional wisdom on its head with findings that TSR is a relatively poor choice for an LTI measure. While rTSR plans are effective at aligning pay with TSR, these plans suffer from a number of drawbacks, including:

- TSR poorly defines management’s operating objectives
- TSR can become detached from financial performance (which arguably better reflects the result of management actions and achievement of business objectives)
- TSR plan accounting expenses can be disconnected from the actual value delivered because of complex accounting requirements.

Many companies that adopted rTSR plans in the late 2000s have now completed several three-year performance cycles and are seeing the challenges associated with these plans firsthand. As boards and management teams digest our new research and experience the various challenges with their own plans, the natural question then becomes, “What measures should we use instead?”

Guided by these concerns, companies must re-evaluate the role of rTSR plans within their incentive pay constructs. That evaluation process begins with boards and management in agreement that alignment of pay with TSR represents the ultimate goal. Boards and management must then

### How to Evaluate Total Shareholder Return Plans

**UNDERSTAND THE ROLE TSR** currently plays in your plans. Review the portion of total executive pay based on a TSR plan and the portion of total long-term incentives based on a TSR plan. The answer to these two concepts should be reconciled with industry standards and the company’s sense of potential shifts.

**IDENTIFY OTHER VALUE DRIVERS** through data-intensive analytics. Critically evaluate operational drivers and other measures of strategy execution and proof the relationship between alternative performance measures and shareholder value, appropriately considering time series lead/lags, the universe of available data and the broader economic environment.

**DETERMINE HOW ALTERNATIVE PERFORMANCE MEASURES** can be incorporated into the measurement framework. The design phase operationalizes plan mechanics and determines how a specific performance measure is incorporated into the incentive plan construct.

**EFFECTIVELY COMMUNICATE** the reasons for change. It is imperative to talk to employees and the investment community. With employees, the focus should be on the impacts on them and what they can do to drive performance. With the investment community, the focus is on why line of sight between strategy execution and executive pay under a modified design construct trumps TSR-based play plans.
recognize that using performance measures other than rTSR simply acknowledges that there are multiple paths to the same destination. Just as it is expected that companies quantitatively demonstrate pay and performance alignment, companies should also be able to quantitatively demonstrate the degree to which specific performance measures drive shareholder value. A performance measure with limited ability to drive shareholder value is of limited use in aligning pay with performance.

Some factors that should be considered include what is occurring in the broader macroeconomic environment, the leading and/or lagging impact of various measures on shareholder value and the similarity in the relationship between performance and shareholder value at similarly situated companies. Bear in mind that reviewing the incentive metric practices of similar companies can be a double-edged sword. While the practices of other organizations present some safety in numbers, performance measure selection ultimately should be driven by company-specific factors to ensure alignment with a company’s business strategy and human capital requirements.

The process to identify and select alternative performance measures can be a challenge, but it starts with a comprehensive understanding of what drives your company’s stock price over the long term. For many companies, this comes down to measures of profitability and returns on capital. We refer to these measures as centerpiece financial measures.

In addition to long-term profitability and returns on capital, specific, targeted financial performance measures more accurately assess management’s strategy execution. It is these company-specific measures that reflect the uniqueness of a company’s business strategy and, in turn, create differences in incentive plan design.

As financial performance metrics are lagging indicators — based on decisions already made and actions already taken — it may be appropriate to include operational measures and other leading indicators that are closely
Unaligned with the execution of business strategy. These lead measures exist to support the centerpiece financial measures and serve to round out the incentive plan performance focus.

In the debate to reduce the role of, or even abandon, a TSR plan, it is useful to dispel the prevailing notion that proxy advisory firms have expressed a preference for rTSR plans. This is untrue. Proxy advisory firms are not concerned with the specific measures within a company’s incentive plans. They are simply looking for proximate alignment as evidenced by what counts for a passing grade.

Companies using relative total shareholder return already might worry about the optics of reducing the portion of pay that is directly dependent on it. However, this concern can be assuaged by ensuring that a sufficient percentage is delivered in equity and by adopting robust share ownership requirements or holding requirements that continue beyond retirement or other termination. This ensures that executive wealth is sufficiently tied to shareholders’ interests.

Also of paramount importance is an effective performance measurement communication strategy when talking to employees and the broader investment community. In talking to employees and plan participants, it is important to create a cohesive story on the importance of establishing performance measure line of sight between decision making and pay. By shifting from an rTSR plan to a plan based on financial and/or operational performance, telling employees that they will be given additional control over their own compensation destiny, as opposed to being overly exposed to market vagaries, can be powerful. In messaging to the investment community around performance measurement, the focus pivots to one of alignment with strategic objectives, key measures of financial performance that align with value creation and, finally, shareholders.

While we question the usefulness of rTSR as an incentive measure, we understand its appeal. Relative TSR plans are simple to communicate and effectively align pay with TSR, and it is difficult to be criticized for “doing what everyone else does.” Unfortunately, “doing what everyone else does” never has and never will be an effective pay strategy. Companies must step back, re-evaluate the role of their rTSR plans and critically evaluate alternative performance metrics. In making the move, companies don’t need to make revolutionary change. Baby steps are reasonable. For those on the fence of reducing the role of TSR and or eliminating it altogether, it is worth remembering that fortune favors the bold.

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